Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

L&T Technology Services

Six steps to success

IT & ITES	Sharekhan code: LTTS	Analyst Day Meet

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 4,051**	
Price Target: **Rs. 4,650**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

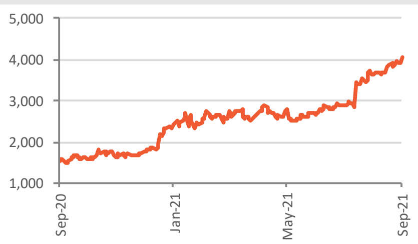
Company details

Market cap:	Rs. 42,558 cr
52-week high/low:	Rs. 4,068 / 1,465
NSE volume: (No of shares)	3.9 lakh
BSE code:	540115
NSE code:	LTTS
Free float: (No of shares)	2.7 cr

Shareholding (%)

Promoters	74.2
FII	9.4
DII	7.4
Others	9.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	11.2	49.9	49.6	164.9
Relative to Sensex	3.7	39.2	37.2	116.9

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy on L&T Technology Services (LTTS) with a PT of Rs. 4,650, given its strong clientele, full spectrum of services and strong demand in the digital engineering space.
- LTTS aims to focus on six strategic areas with strong demand. A customer-centric approach, strong execution and long-standing relationship with clients would help LTTS to capture emerging opportunities.
- The management eyes $1-billion in annual revenues by Q2-Q3 of FY2023, which translates to a 3.3-4% CQGR. Further, in the long term, it eyes $1.5 billion in revenue in FY2025.
- We expect USD revenue/EPS to clock a CAGR of 19%/ 28%, respectively, over FY2021-24E. Management aims to achieve 18% EBIT margin by FY2025, aided by higher revenue growth, improving margins in the hi-tech vertical and change in revenue mix.

On its annual investor and analyst day 2021, L&T Technology (LTTS) highlighted on its business strategy, both near-term and long-term outlook for 2025, a six-dimensional growth path, six strategic bets, customer-focused approach to achieve industry-leading growth and a sustainable operating model. The company wants to be among the top 5 global pure play engineering services providers of choice. We believe the company's strength around 4Es (complex engineering, digital engineering, design engineering and business engineering) and strong frameworks across segments will provide significant headroom for growth.

- **Focused bets on six strategic areas:** The management indicated that it would focus on six strategic areas – electric, autonomous and connected vehicles, med-tech, 5G, artificial intelligence and digital products, digital manufacturing, and sustainability. LTTS would also focus on scaling up softwarization in product engineering. We believe LTTS has a strong position to capture opportunities in these fast-growing strategic areas.
- **Driving growth:** The management aims to achieve $1 billion annual revenue run rate by Q2-Q3 of FY2023, which translates 3.3%-4% CQGR. On long term, it aspires to achieve $1.5 billion in revenue in FY2025, which implies a 19.5% CAGR over FY2021-FY2025.
- **Eyeing 18% EBIT margins by FY2025:** The management cited that the savings from WFX efficiencies and set up of facilities in tier-II cities would invested in security, cloud, labs and training. Hence, the margin improvement would be gradual, which will be aided by revenue growth, cost rationalisation measures.It targets to achieve EBIT margin at 18% by FY2025.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 4,650: LTTS is one of the best plays in the faster growing ERD space for its multi-industry expertise, deep engineering capabilities, end-to-end offerings, and long standing relationships with large enterprises worldwide. We believe LTTS is well-placed to gain market share among global competitors because of being the preferred engineering partner among clients and strong customer centric approach. We expect LTTS' USD revenue and earnings to post a CAGR of 19% and 28% over FY2021-FY2024E. At CMP, the stock trades at 36x/31x its FY2023E/FY2024E earnings estimates, which justifies premium valuations, given anticipated large deal wins in the coming quarters, presence in the fast-growing ERD segment, and consistent pay-outs. On account of improving return ratios and free cash flow (FCF) generation, we retain a Buy on LTTS with a revised PT of Rs. 4,650..

Key Risks

Macroeconomic uncertainties could affect earnings. Further, loss of key customers and/or lower ERD spends/R&D budgets may impact the growth trajectory.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	5,449.7	6,497.8	7,816.9	9,460.6
OPM (%)	18.5	21.0	20.8	20.4
Adjusted PAT	663.3	948.7	1,188.6	1,381.1
% y-o-y growth	-19.0	43.0	25.3	16.2
Adjusted EPS (Rs.)	62.9	89.7	112.4	130.6
P/E (x)	64.4	45.2	36.0	31.0
P/B (x)	12.1	10.2	8.4	7.1
EV/EBITDA (x)	40.1	29.5	24.5	20.4
RoNW (%)	21.3	24.9	26.0	25.2
RoCE (%)	21.3	25.7	26.8	27.4

Source: Company; Sharekhan estimates

A six-dimensional growth path

The company operates in five segments such as – medical devices, transportation, industrial products, plant engineering and hi-tech and four horizontals including mechanical, VLSI systems, digital manufacturing and digital products. The company operates in US, Europe, Israel, Japan and India with 57 of the top 100 spenders as clients. The company aims to be among the top 5 global pure play engineering services provider of choice. Hence, the company identified six dimensional glide path – (1) industry leading growth – over 4% q-o-q organic growth over last four quarters and expect to continue the growth momentum in coming quarters, (2) Customer centricity – meet customers' requirements and strengthen its relationship with clients. Focus will remain to improve net promoter score (NPS), (3) People engagement – ability to scale, (4) Technology quotient – patents to file for its and customers' technologies and technical certification for its employees, (5) Sustainable operating model – win deals, predictable margins and intelligent investments and (6) environmental social and governance (ESG) to achieve its vision.

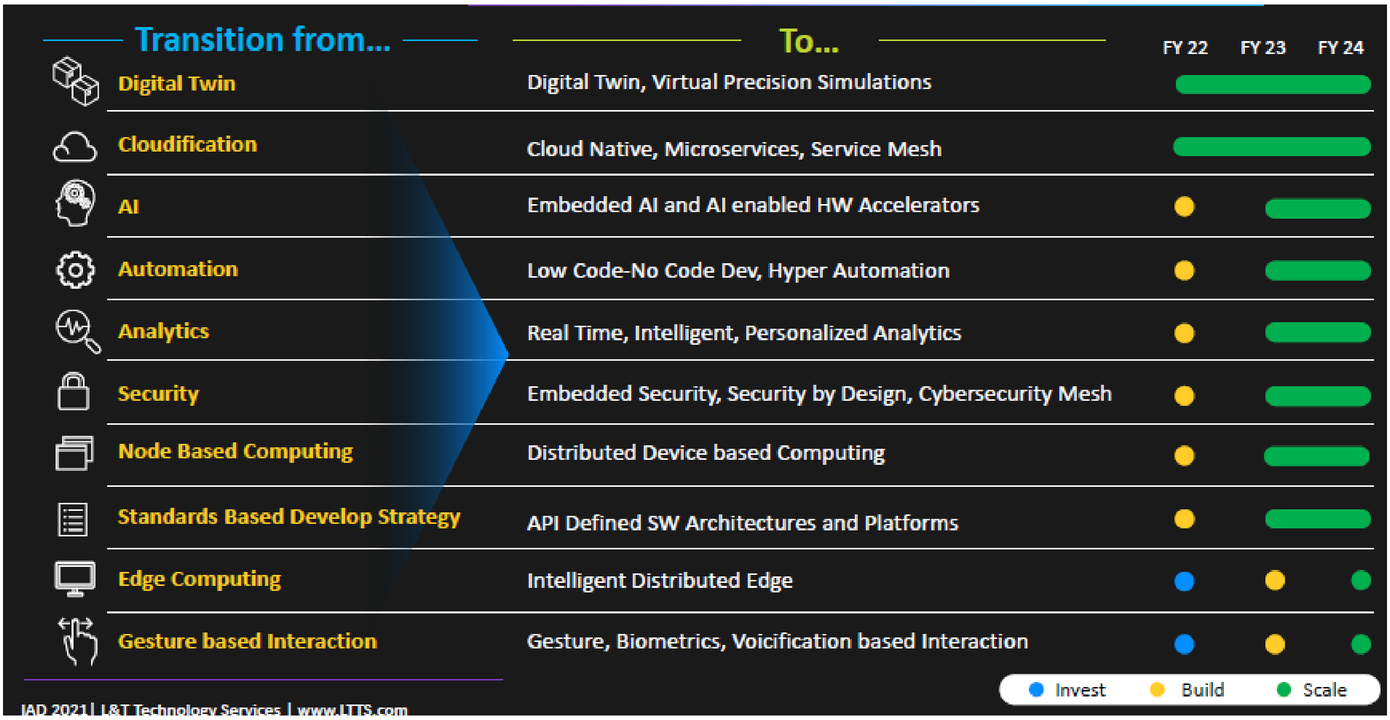
Focused bets on six strategic areas enable LTTS to capture emerging opportunities

LTTS' expertise in providing integrated services in engineering and technology has helped its customers implement their digital transformation roadmaps. LTTS' management indicated that it would focus on six strategic areas – electric, autonomous and connected vehicle (EACV), med-tech, 5G, AI and digital products, digital manufacturing and sustainability. We expect strong demand trends (1) **EACV** remains the dominant trends in the automotive market. It is estimated that 25% of cars to be EV by 2025, (2) **med-tech** – the company focuses on device engineering, digital and decision support and QARA regulatory standards.the spend on this space would be at $200 billion by 2025, (3) **5G** – The acquisition of Orchestra has strengthened its capabilities in areas of network engineering and operations (for 5G, IoT, RAN, and core networks) and enterprise mobility. LLTS helps clients in 5G device design & integration, network assurance, private networks, lab-as-a-service and end-to-end test and automation area. The market size is estimated to be at $155 billion by 2025, (4) **AI and digital products** is expected to make its way in every application in the engineering space. The market size would be at $100 billion by 2025, (5) **Digital manufacturing** due to reducing operational visibility, reduce costs, optimise production time, and deliver exceptional customer support. The market size would reach $475 billion by 2025, (6) **Sustainability** – carbon neutrality and preserving resources are extremely critical for the future. Enterprises in most industries have started moving towards clean energy, non-fossil fuels, and renewable energy, among others. There are 17 goals being defined by United Nations and management believes that LTTS can meaningfully address 6-7 of these dimensions.The market size would be at $400 billion by 2025. LTTS has been building labs in these six strategic areas. Further, the company has been focusing on deal pipelines and closing deals in these areas. Apart from these six big bets, LTTS is focusing on scaling softwarization in product engineering. Digital Twin and cloudification are currently scaling up, while the company expects AI, automation, analytics, security, node-based computing and standard based develop strategy would scale up from next year. The company has been investing on edge computing and gesture-based interactions and it believes that these offering would be scaled beyond FY2024. With strong digital engineering capabilities and continued investments in disruptive technologies, we believe LTTS has a strong position among peers to capture opportunities in this fast-growing ER&D services market.

Investing on six strategic growth areas

Source: Company

Continue to scale in softwarization in product engineering

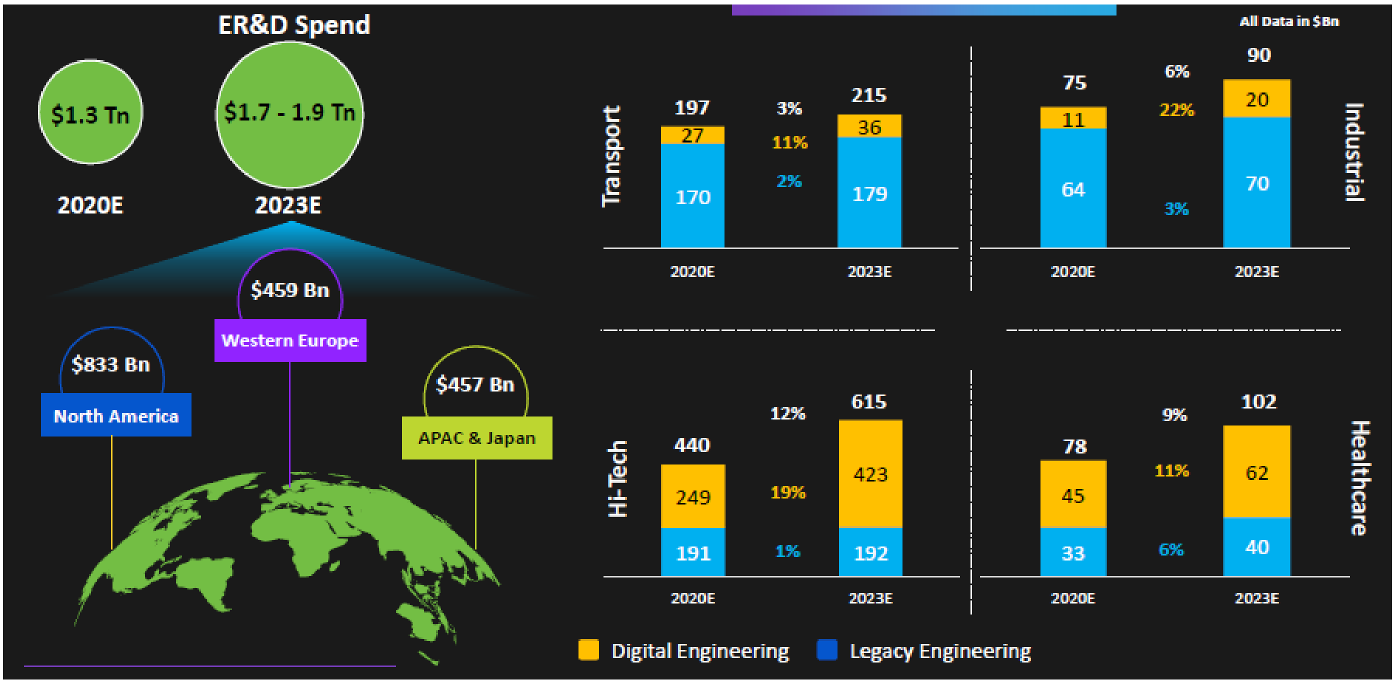


Source: Company

Strong demand for digital engineering

There has been strong demand for digital engineering across verticals and LTTS expects spends around digital engineering area to remain strong for next 15-18 months. The company's customers focus on smarter products and platforms. Among verticals, the digital engineering spends are expected to grow at a faster rate of 22% and 19% CAGR in industrial and hi-tech vertical respectively over FY2020-23E. There is significant demand in the hi-tech space given democratisation of software and hardware and higher demand for semiconductors because of higher number of connected devices and geo-political changes.

Strong demand for digital engineering



Source: Company

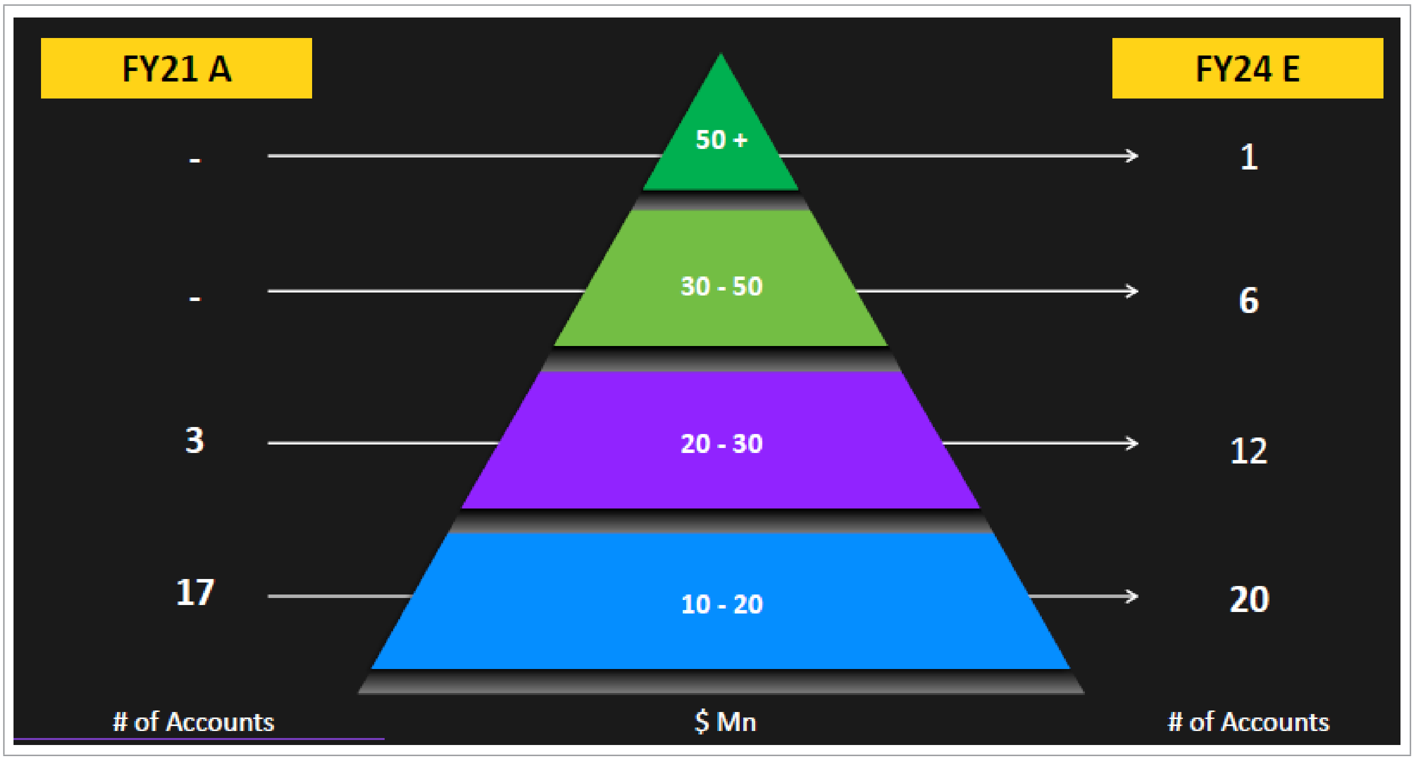
Aiming for a strong foundation with right investments

LTTS launched its CTO office in FY2017, which institutionalised in the company and incubates next-gen solutions. The investment in VLSI design services in 2017 shows the company's foresight of future requirements of technologies. In addition, the company acquired Esencia Technology in the VLSI space in FY2017 to strengthen its capability in the chips space. Apart from Esencia Technology, the company has acquired Graphene Semiconductor and Orchestra Technology in Semiconductor and network engineering and enterprise mobility space in FY2019 and FY2021 respectively. The company set up security practices in FY2018, digital engineering center (Sweden) in FY2019, defence center in FY2020 and transportation center of excellence in Germany in FY2021. Given its strong capabilities across the verticals and right investments on capabilities, the company has secured two $100 million deals in hi-tech and oil & gas space in FY2018 and FY2021 respectively. The company's number of client increased from 223 in FY2017 to 306 in FY2021, while the number of patents increased from 254 to 650 in the same period. Further, the company's digital revenue contribution to total revenue increased from low teens to 54% in Q1FY2022, which indicates the company's right investment strategies. The company is ranked among top 5 worldwide in terms of qualitative ERD services ratings.

Customer-centric approach to help win large deals

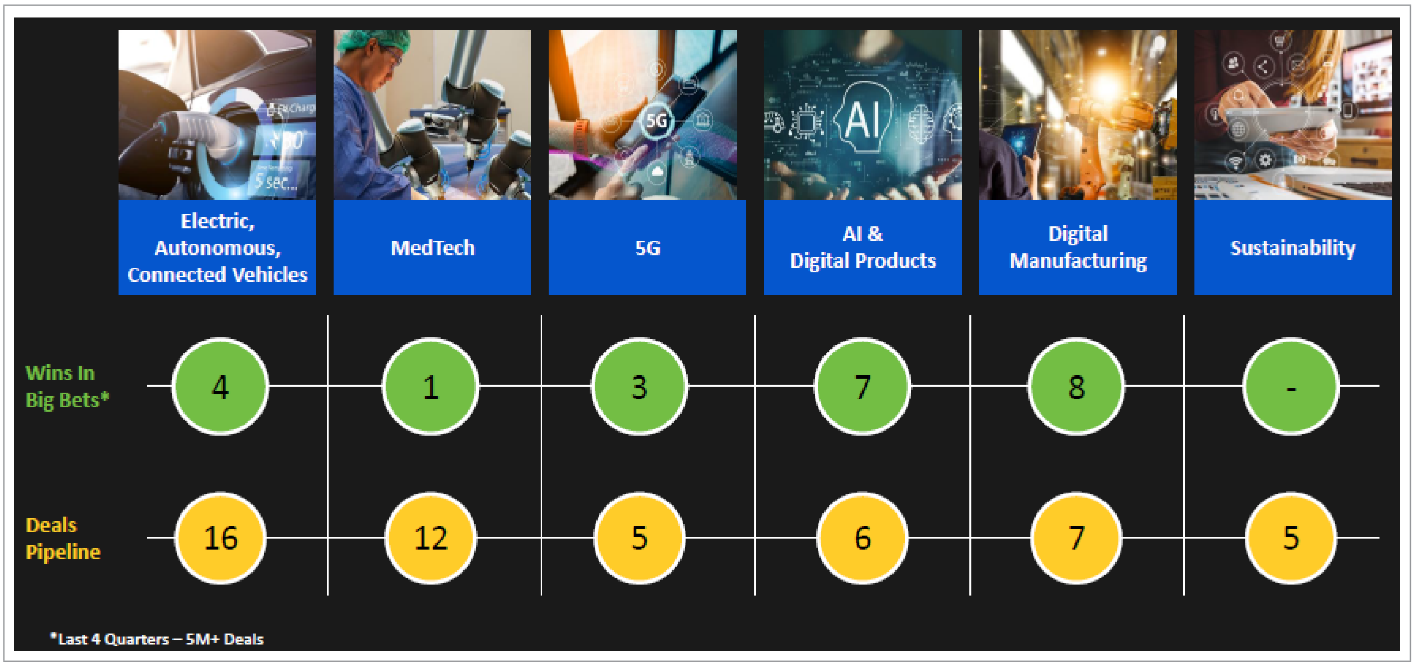
LTTS has been focusing on expanding four pillars such as (1) super sizing accounts – looking at delivery by staying close to customers and empowering the leaderships. Further, the company focuses on solving complex problems of the customers to win large deals from existing customers. The company expects 15-20% growth per customer by super-sizing the account. The company expects its $50 mn+ and 30mn + client categories would increase to one and six in FY2024E from NIL currently, (2) mega deals – the company focuses to partner with its customers in their product development and participate in its clients' structured ideation process. In addition, the company has created a large deal team and alliances and partnerships for large deals, (3) adjacents – the company focuses to work with disruptive customers as they are well funded to work on new themes, and (4) Geo-strategy – expanding medical and hi-tech offerings in Europe. The company has won 39 large deals and 19 logos in the last four quarters. Further, both deal wins and the deal pipeline have remained strong across all its strategic focus areas in the last four quarters. Management believes that its customer centric approach would help it to become preferred partner for future-driven organisations, which would support it for industry leading growth going ahead.

Expect strong growth in number of accounts



Source: Company

Wins across strategic areas



Source: Company

Eyeing strong execution

The company focuses on four tenets such as (1) Tech celebration – investments on capabilities ahead of time, innovation programs and technology partnerships around six bets, (2) Customer delivery excellence – delivering value to the customers by investing on newer technologies and innovation labs, (3) Talent investments – strong framework to put top talents on fast track of career and leadership development, (4) System cognition. The company has been investing on talents, technologies and platforms aggressively as the company is entering into the era of extreme offshoring and higher work-from-anywhere (WFX) culture.

Strong digital engineering spends create huge upside potential for LTTS

The management highlighted that the technology has been significantly integrated into consumer contexts, services, and products. The pandemic has accelerated the adoption of technologies as these technologies are creating huge opportunities to drive operational efficiency, reduce costs, deliver new services to consumers, and generate new revenue sources. In this rapidly disrupting world, the global IoT devices increased from 0.8 billion in 2010 to 8.7 billion in 2020 and is expected to increase to 25 billion by 2030. Similarly, industrial robots installed increased from 121K in 2010 to 465k in 2020 and is expected to increase to 20 million in 2030.

Engineering and R&D (ERD) spend is expected to increase from $1.4 trillion to $1.9 trillion by 2023. The management sees strong technology adoption across its verticals. it believes 75% of home devices will be remotely monitored and controlled, while 71% of vehicles will be fully electric vehicle by 2030. As the world is moving at a faster and better latency speed of connectivity, there would be huge opportunity for companies in ERD space. This provides a huge market upside to LTTS given its multi-domain expertise and strong engineering heritage.

Focus on accelerating growth; expect $1.5 billion revenue by FY2025

The management reiterated its annual USD revenue growth guidance of 15-17% for FY2022E. In the medium-term, the company aims to achieve $1 billion in revenue by Q2-Q3 of FY2023, which translates 3.3%-4% CQGR. On long term, it aspires to achieve revenues of $1.5 billion by FY2025, implies 19.5% CAGR over FY2021-FY2025. The growth would be led by higher spends in digital engineering, broad-based growth across its verticals, diversified exposure and incremental revenue contribution from acquisitions. The acquisition strategy would be based on building capabilities around the white space and revenues of the acquired entity would be at $20-100 million. Consistent growth in digital share indicates the company's continuous investments on newer technologies. Further, LTTS is being considered as preferred partner of clients because of speed, scale and talents.

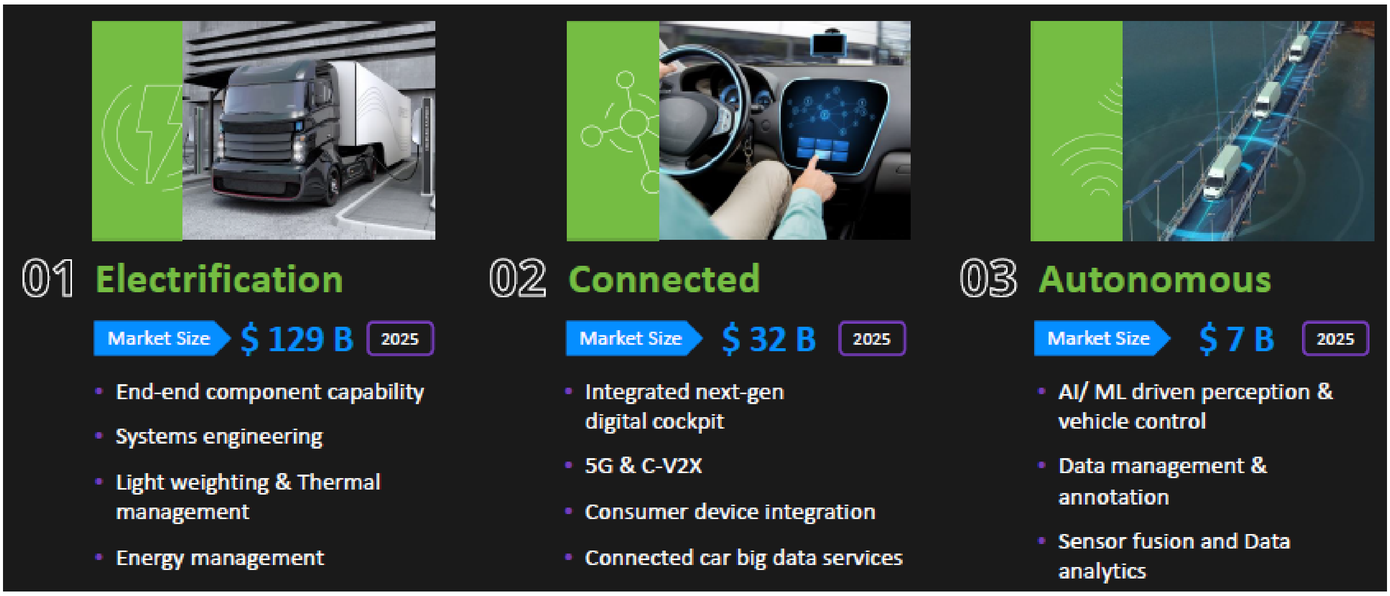
Expect 18% EBIT margin in FY2025

LTTS reported an EBIT margin at 17.3% in Q1FY2022 due to margin improvement across verticals. Management targets to achieve margins of 18% by FY2025 despite investments in technologies, building labs and talents. Management cited that the savings from WFH efficiencies and setting up of facilities in tier-II cities would invested in cybersecurity, cloud, labs and training. Hence, the margin improvement would be gradual, which will be aided by revenue growth, cost rationalisation, higher utilisation, and pyramid rationalization. Further, LTTS will focus on improving margin in the telecom and hi-tech vertical, boost growth in higher-margin verticals, and shift portfolio towards digital engineering.

Other key highlights in analyst meet

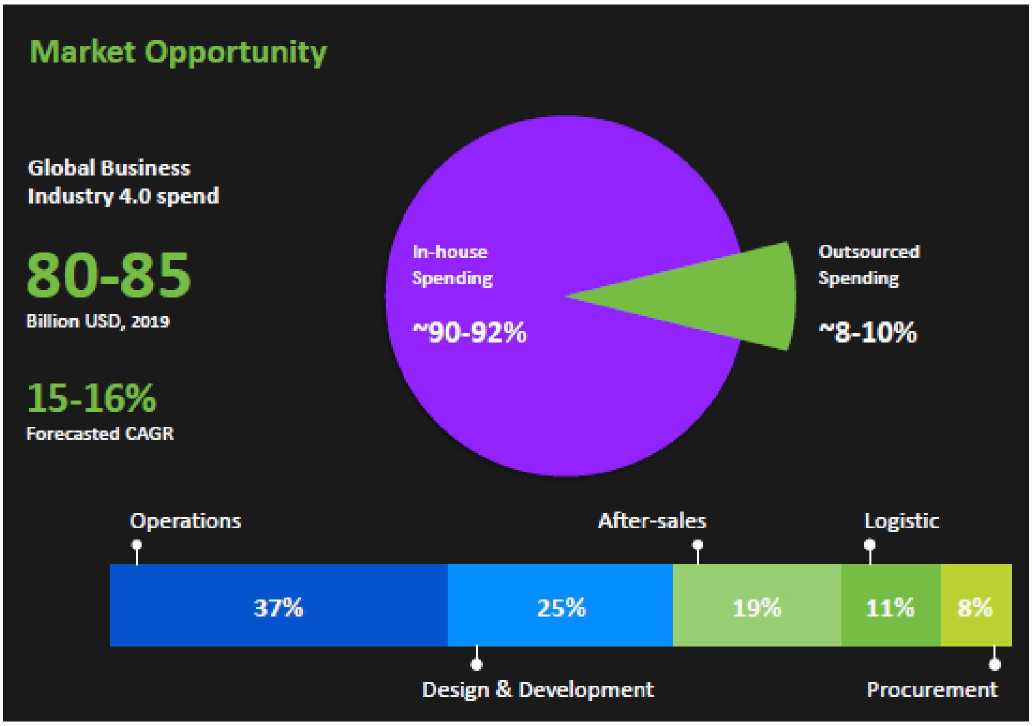
- The management highlighted that it sees three major changes such as (1) higher adoption of digital products, (2) higher offshoring and (3) cybersecurity after the outbreak of COVID-19.
- Customers' core and non-core businesses have been changing, which is helping LTTS win more deals. Changes in core and non-core business depend on the lifecycle of product and technology.
- The management sees some customers are looking for long term contract duration in the ERD space because of consolidation of budgets and improving predictability, which was not the case earlier.
- The outsourcing in transportation is at double digit percentage of customer's total budget, while medical and plant engineering remains at lower teens. Outsourcing in hi-tech and industrial products remains at double-digit percentage of clients' total R&D budget. Management indicated that the sales cycle has reduced by 30% over last six months.

Strategy & credentials in EACV



Source: Company

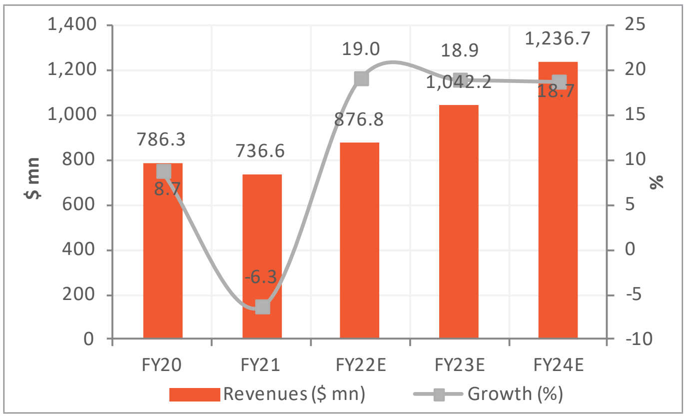
Market opportunity in digital manufacturing transformation



Source: Company

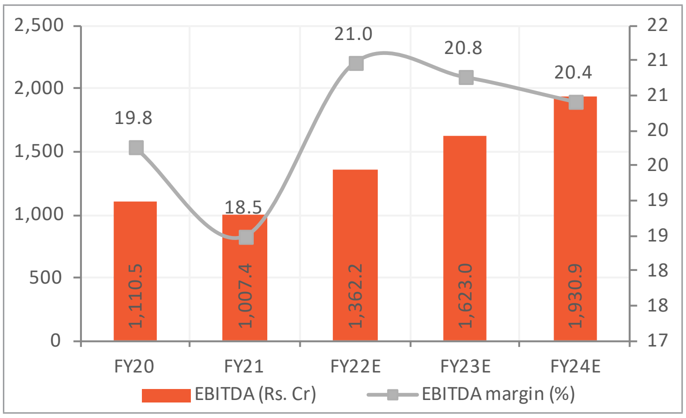
Financials in charts

Revenue ($ mn) and growth (%)



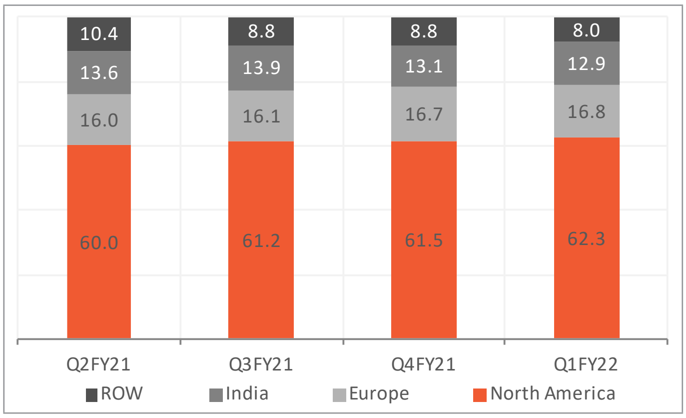
Source: Company, Sharekhan Research

EBITDA and EBITDA margin (%)



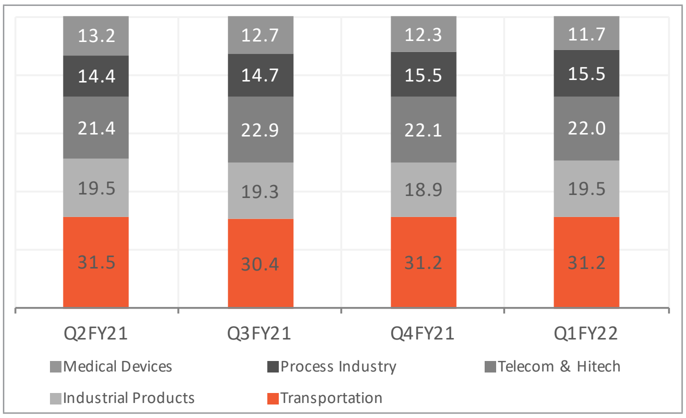
Source: Company, Sharekhan Research

Geography-wise breakdown (%)



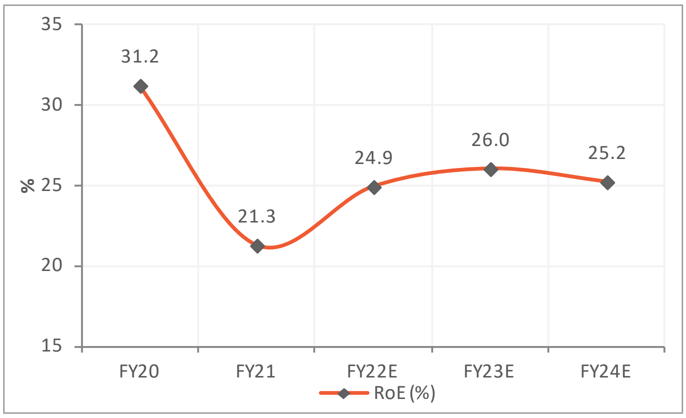
Source: Company, Sharekhan Research

Vertical-wise breakdown (%)



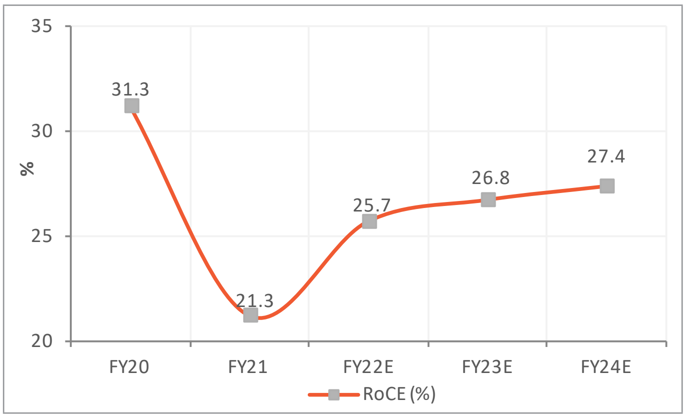
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

Sector view – Large addressable market provides sustainable growth opportunities

Global ERD spends remained resilient in CY2020 despite the outbreak of COVID-19, though the growth rate moderated to ~3% as manufacturing-led verticals such as aerospace, automobiles and manufacturing tighten purse-strings (declined by 4.6% in CY2020). Total global ERD spends stood at $1.5 trillion in 2020 and are expected to touch $1.9 trillion by 2023.The global outsourced ERD addressable market stood at $90 billion, of which India outsources $33 billion. Of this, GICs export ~$19 billion exports and the remaining $14 billion by third party ESPs. Indian ESPs will grow at a faster rate as compared to global peers owing to their ability to leverage robust digital engineering talent chains. According to Zinnov, the digital engineering market is expected to post a 19% CAGR from $545billion in 2020 to $911billion by 2023. It is estimated that hi-tech and service-led verticals' spending on ERD would outpace growth of ERD spend of manufacturing-led verticals over FY2020-FY2023E. Digital engineering to ERD spend ratio is likely to reach 47% in 2023 from 36% in 2020.

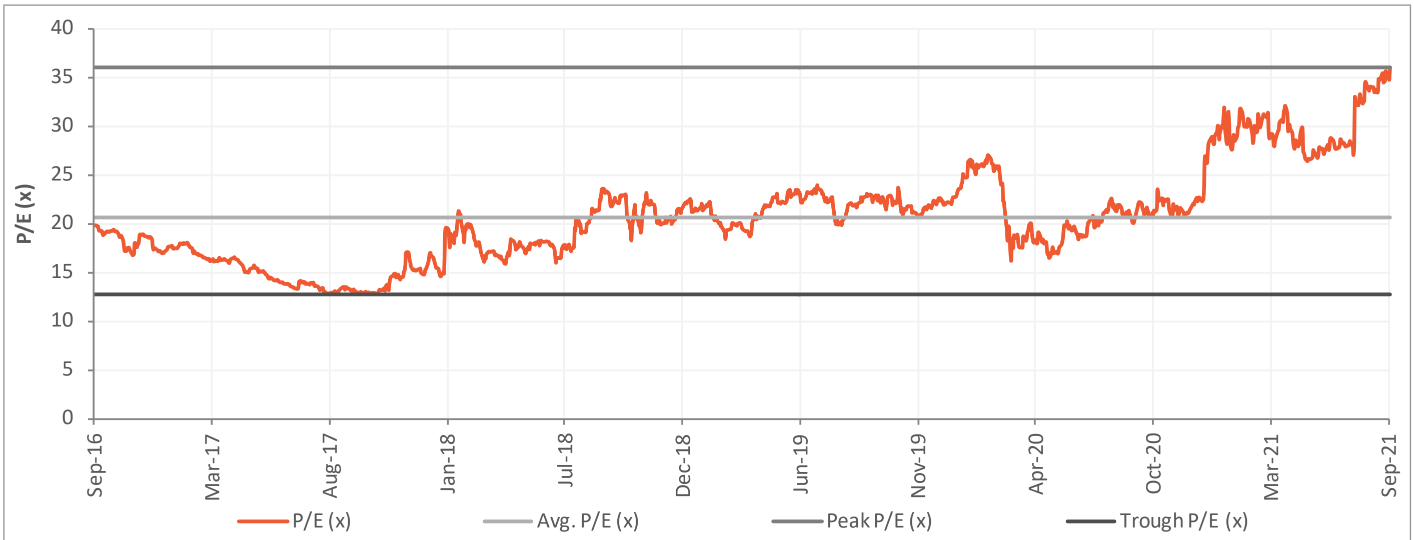
Company outlook – Broad portfolio to create long growth runway

LTTS is the third-largest ESP in India and is welldiversified across verticals. The large ERD addressable market and a huge scope in deepening relationships with its top-30 customers provide multi-year sustainable growth prospects. Technology shifts in verticals are also positive for LTTS as they create huge growth opportunities for ESPs. We expect strong growth from FY2022Ebecause of rising spendsin both digital engineering and legacy engineering areas.

Valuation – Best play in the ERD space

LTTS is one of the best plays in the faster growing ERD space for its multi-industry expertise, deep engineering capabilities, end-to-end offerings, and long standing relationships with large enterprises worldwide. We believe LTTS is well-placed to gain market share among global competitors because of being the preferred engineering partner among clients and strong customer centric approach. We expect LTTS' USD revenue and earnings to post a CAGR of 19% and 28% over FY2021-FY2024E. At CMP, the stock trades at 36x/31x its FY2023E/FY2024E earnings estimates, which justifies premium valuations, given anticipated large deal wins in the coming quarters, presence in the fast-growing ERD segment, and consistent pay-outs. On account of improving return ratios and free cash flow (FCF) generation, we retain a Buy on LTTS with a revised PT of Rs. 4,650.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Cyient	987	11	10,867	22.1	19.4	13.1	10.9	3.7	3.2	16.0	16.8
Tata Elxsi	4,923	6	30,661	60.6	49.9	44.3	36.0	18.0	14.2	29.7	28.4
LTTS	4,051	11	42,558	45.2	36.0	29.5	24.5	10.2	8.4	24.9	26.0

Source: Company; Bloomberg

About company

LTTS is a leading global ERD services company, backed by the rich engineering expertise and experience of parent company, Larsen & Toubro. LTTS is a pure-play Engineering Design Services firm presentacross multiple verticals (transportation, industrial products, telecom and hi-tech, medical devices, and process industries). The company derives 62.3% revenue from North America, 16.8% from Europe, 12.9% from India, and 8.0% from Rest of the World (RoW). The company offers ERD practices to 53 of the top R&D spenders worldwide. LTTS also has IP and platforms, which it independently sells to clients.

Investment theme

LTTS currently generates a mere 0.5% of its Top-30 (T-30) customers' R&D spends ($75 billion) as revenue ($376 million), which provides a long runway for growth. We believe the multi-sectoral presence and robust horizontal technology practice would help LTTS to deliver sustainable revenue growth momentum. Additionally, technology shifts in verticals is positive for LTTS as any change in technology creates huge growth opportunities for ESPs.Unlike peers, LTTS has a broader portfolio, which helps the company to mitigate the risk relating to vertical-specific cyclicality. We believe LTTS is well poised to deliver strong multi-year growth going forward, led by leadership depth, broad client portfolio, and multi-domain expertise across verticals and under-penetrated ERD outsourcing market.

Key Risks

1) Rupee appreciation and/or adverse cross-currency movements, 2) any hostile regulatory visa norms could impact employee expenses, 3) macrouncertainties could adverselyaffect earnings, 4) loss of key customers, and 5) lower ERD spends/R&D budgets

Additional Data

Key management personnel

A.M. Naik	Non-Executive Chairman
S.N. Subrahmanyan	Vice Chairman
Amit Chadha	Chief Executive Officer
Rajeev Gupta	Chief Financial Officer
Abhishek Sinha	Chief Operating Officer (COO)

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Nippon Life India Asset Management Ltd	1.42
2	Wasatch Advisors Inc	1.17
3	Invesco Asset Management India Pvt	0.73
4	Vanguard Group Inc/The	0.71
5	HDFC Asset Management Co Limited	0.61
6	Axis Asset Management Co Limited	0.60
7	UTI Asset Management Co LTD	0.45
8	Sundaram Asset Management Co	0.41
9	JPMorgan Chase & Co	0.39
10	Goldman Sachs Group Inc/The	0.39

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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